APPENDIX

Notes for FOMC Meeting
October 1, 1985

Sam Y. Cross

Since the Group of Five's September 22 meeting, the dollar has dropped sharply. By this morning, it had fallen about 9 to 10 percent against the Japanese yen, 6 percent against the German mark and 2 percent against the pound sterling. This drop in dollar rates considerably more than offset the rise in the dollar that had occurred after your last meeting up until mid-September.

The G-5 agreement had an immediate and strong effect, partly because its timing came as a surprise. But even more importantly, market participants were impressed by the fact that the initiative had come from the United States. They interpreted the agreement as a major reversal of the Administration's attitude toward a strong currency as well as toward intervention. And at least initially they interpreted the agreement as eliminating any possibility that might still have remained, following the lower-than-expected "flash" GNP figure for the third quarter, that U.S. monetary policy might be tightened.

In these circumstances, the dollar fell sharply last Monday even before any official intervention occurred. With Tokyo closed for a holiday, the first central bank operations were in Europe. The dollar had already fallen 3 to 4 percent against major foreign currencies by the time the Bundesbank stepped in to sell dollars at the afternoon fixing in Frankfurt. Later on that day, the U.S. authorities took an opportunity to resist a rise of the dollar from the lower levels, and we sold $70 million against the Japanese yen and $79 million against German marks. As has continued to be true throughout the last week, the Fed operated in a relatively visible manner, in order to demonstrate our preparedness to intervene.

For the next couple of days there was some skepticism in the market that the lower dollar rates initially reached after the weekend would be maintained. Market participants did not find clear guidance from the vague and bland wording in the communique about policy adjustments the G-5 governments had agreed upon to support the desired "upward adjustment" in other currencies against the dollar. And they doubted that foreign exchange market intervention alone could achieve such an objective.

Consequently, a number of banks' commercial customers responded to the apparently attractive rates to buy dollars. This phenomenon was the most dramatic in Tokyo where, when the market opened on Tuesday after a three-day weekend, dollar demand from commercial entities spurred a record turnover of nearly $5 billion in spot trading between the dollar and the yen. The Bank of Japan responded by selling that day, to limit the dollar's recovery. The size of the Bank of Japan's operations was accurately gauged in the market. This operation was followed up by interventions later in the week, recurrent statements by Japanese officials indicating they wanted still greater appreciation of the yen, and talk of some new fiscal stimulus for next year. As a result, market participants have come to perceive the central banks to be more firmly committed than in the past to a serious, joint effort to bring the dollar down.

Since the G-5 meeting, the U.S. authorities have sold dollars in the exchange markets on all but one day. We operated even last Friday, when hurricane Gloria brought foreign exchange trading to a virtual halt in new York and our transactions had to be done with banks in Chicago, London, and Toronto. In total, in the past six days, we sold $408 million, of which $224 million was against yen and $184 million was against marks. These sales were shared equally between the Federal Reserve and the Treasury. The Desk's operations have been widely observed, particularly in dollar/yen. We operated when the dollar was rising, believing it not appropriate for the U.S. authorities to push the dollar down in a way that could start an uncontrolled fall. At times we have aimed at permitting the dollar to recover temporarily in order to maintain some sense of two-way risk.

In all, official dollar sales by the G-5 central banks since the G-5 meeting have come to about $2-1/2 billion. Of this amount, the Bank of Japan has done   The United States' share of dollar sales has been only about 15 percent of the total. But then, the drop in the rate has perhaps been faster during the first week than we might have thought, and we have not yet been severely tested in the U.S. market. Over a longer time period, we might expect the U.S. share to be about double that rate.

The dollar's fall against the German mark has put several other European currencies under pressure within the EMS. Not only the French but also the Italians and the Belgians have had to intervene to maintain their place in the EMS. At the request of the Bundesbank and to support the G-5 agreement, these operations by the others have almost entirely entailed sales of dollars. As a result, almost all of the G-10 countries have been selling dollars during the past six business days. Net dollar sales by the smaller countries of the G-10 have amounted to another $3/4 billion or so of dollar sales.

Apart from our intervention, the only other operation I have to report is that Argentina completed yesterday the repayment as scheduled of its drawing on the swap agreement with the United States Treasury. The repayment of $71 million followed a payment last August 15, and extinguished the Treasury's facility. It was made using receipts the same day of Argentina's drawing from the IMF under its new economic stabilization program. Also completed yesterday through the Federal Reserve Bank of New York were the repayments of outstanding credits to Argentina from twelve foreign central banks, representing their part of the $483 million cooperative bridging facility established on June 18, 1985.

Recommendations

Mr. Chairman, I recommend that the Committee should consider increasing the Authorization's limit on foreign currency balances to be held by the Federal Reserve System and also raise the informal limits on individual currency holdings. It is, of course, not possible to predict how large our intervention operations will be in the next several weeks following the G-5 meeting. But as you know, the United States has conveyed to the other G-5 authorities that we are prepared to intervene in considerable size if necessary. Most of the central banks involved anticipate the market, sooner or later, will seek to test our resolve. Under the appropriate circumstances I imagine we would want to be prepared for some heavy days of intervention. Assuming these operations continue to be shared equally between the Federal Reserve and the Treasury, we could easily reach our informal limits in the size of the System's open position in individual currencies before your next meeting.

The most binding restraint at the moment is the informal limit on the size of our yen balances--both because we have only about $200 million available and because we expect to be focusing a major part of our operations in that currency. But also, we have only limited leeway in marks, less than $500 million. It would be possible to raise the informal limits on the System's open position without having the Committee make a formal change in the Authorization. But I believe it would be far better if an increase in the Authorization should become needed in the next month or two, to do so now.

Accordingly, I recommend that the Authorization limit should be increased from the present $8 billion to $10 billion. In the informal limits, I recommend that the limit on the total be increased also to $10 billion; the limit for German marks to $6 billion; the limit for Japanese yen to $3 billion; and the limit for all other currencies to $1 billion.

PETER D. STERNLIGHT

NOTES FOR FOMC MEETING

OCTOBER 1, 1985

The Domestic Desk began the last intermeeting period aiming for the slightly greater measure of restraint that we had begun to seek shortly before the August meeting. Reserve paths were constructed using adjustment and seasonal borrowing of $425 million, the midpoint of the Committee's $350-500 million range. About midway through the interval, with money supply, especially M1, continuing to outdistance expectations and with indications suggestive of somewhat stronger economic growth, the Desk began to seek slightly more restraint, indexed by a path borrowing level of $500 million.

The shift was not readily noticeable in the market, however, where Federal funds trading continued to center around 7-7/8 percent. Indeed, the funds rate has hovered largely in a 7-5/8 to 8 percent range since midyear, when the path level of borrowing was $350 million. Why the lack of more noticeable change? For one thing, the changes in intended borrowing pressure were too modest to have really pronounced effects. Moreover, there was a range of other influences that affected market participants' expectations of where funds "ought" to trade, including the shifting mix of news on the economy and money growth, and the G-5 statement on desired currency rate adjustments. Finally, the actual borrowing levels conformed only roughly to path levels, leaving room for some differences in market interpretations of System intentions. In the view of most market observers, the Systems's intended level of borrowing has been in the $400-500 million range for the past few months and their associated expectation for Federal funds trading has scarcely budged, perhaps barely edging up from a range around 7-3/4 percent in July to about 7-7/8 most recently. Our own expectation would associate $500 million of borrowing with a funds rate centering around 8 percent--and in fact funds have been around 8 in the last couple of days, but this may be largely due to quarter-end pressures and possibly some reserve position uncertainties related to Hurricane Gloria.

. Aside from the hurricane, which led to an early market closing last Friday, the recent period also had some other special factors tending to complicate day-to-day operations. These included a burst of borrowing over the long Labor Day weekend caused largely by a wire transfer problem at a money center bank and an unusually low demand for excess reserves on the part of nonmember institutions whose requirements were being phased up under the Monetary Control Act.

As for actual borrowing, in the first full maintenance period since the last meeting, it averaged about $720 million, reflecting a bulge over Labor Day due to some technical problems. In the second full period, it averaged a close-to-path $515 million. In the first few days of the current period the average was about $950 million, reflecting a hurricane related bulge last Friday and apparently some technical problems yesterday, which was the quarter-end.

The System added about $3.6 billion to its outright bill holdings over the period, including $2.1 billion bought in a market go-around in late August and $1.5 billion bought on various days from foreign accounts. Temporary reserves were added through five rounds of System repurchase agreements and four of customer-related agreements. Major reasons for the additions were increases in required reserves as money supply grew and increases in Treasury balances at the Fed particularly after the mid-September tax date.

Treasury balances, incidentally, are a point of particular uncertainty in the days just ahead. While mid-September tax receipts filled the Treasury's coffers through month end, those balances are now being paid down rapidly. Without action to raise the debt ceiling, the balances are expected to be just barely positive by Monday, October 7, and could turn negative later that week. One result of the Treasury's running out of money is that the drop in their balance at the Fed will release a large amount of reserves. This is a relatively minor consequence because the reserve impact probably can be handled fairly readily through sales of securities, particularly temporary matched-sale purchase transactions. Of greater concern are the disruptions that could come from actually exhausting their cash and having to shut off payments. Also of concern is the prospect of hitting the market hard to raise large sums quickly once a larger ceiling is voted, as it must be.

With a variety of influences at work in the market, interest rates showed small mixed changes over the period. News on the economy alternately suggested some pickup or absence of significant pickup from the sluggish first-half pace. Reaction to money growth information was subdued, and tended to be filtered through assessments of the economy and inflation prospects. Debt limit constraints caused some technical supply shortages that had a temporary depressing effect on yields although at times the market also focussed on the prospective bunching of new issues shortly after the limit is raised. The G-5 announcement of new efforts to coordinate policies among five leading industrial nations, particularly to encourage higher relative values for nondollar currencies, also had somewhat mixed effects. Briefly, it tended to depress rates on shorter maturities in the expectation that the agreement reduced any likelihood for a near-term firming in U.S. monetary policy. At the same time, some observers saw the new approach as increasing the likelihood of a stronger U.S. economy and some pickup in inflationary pressures as imports become less competitive.

On balance, key bill rates showed modest mixed changes over the interval. Bills were auctioned yesterday at about 7.06 and 7.24 percent for the 3- and 6-month issues, just slightly below the 7.14 and 7.28 percent rates just before the last meeting. Net bill issuance declined about $3 billion over the interval, chiefly reflecting a sizable paydown on September 26 because of debt limit constraints.

For Treasury coupon issues, maturities out to about three years were unchanged to down in yield by a few basis points, while most longer issues were up about 5-10 basis points. The volume of new cash raised in the coupon sector was a relatively moderate $10 billion, again reflecting cutbacks or postponements due to debt ceiling delays. Notably, the Treasury delayed the usual end-of-quarter batch of coupon issues that would be reaching the market just about now. The other side of this coin is the likely bunching of perhaps $50 billion of coupon issues--more than half of it for new cash--in a few weeks from mid-October to early November.

In other markets, particular attention focussed on the Farm Credit System issues, where additional adverse publicity in early September caused spreads against Treasury issues to widen from about 20-40 basis points in August to about 60-90 most recently. For a time after the adverse news reports, spreads were as wide as 100 basis points or more. There have been substantial shifts in ownership reported for these issues, with some traditional buyers like small banks and state and local government funds backing away. At the same time, some foreign buyers, money funds and other large investors have taken more. On a smaller scale, Federal Home Loan Bank securities also experienced some widening in spreads following proposals that the Home Loan Banks use part of their capital to bolster FSLIC's resources.

Finally, I should mention the particular impact of Hurricane Gloria on Desk operations last Friday. With dealers manned very skimpily and generally distracted from normal trading concerns, the dealer firms closed at 10 a.m. as regards conduct of business, but there was still much to be done in financing positions and carrying through on previous trading commitments. This created an unusually large and urgent demand to borrow securities to avert delivery failure. In order to alleviate potential disruptions, the Desk, following consultation with the Chairman, relaxed its usual unwillingness to facilitate short sales. Our total lending of securities for the day was about $1.1 billion--roughly two or three times normal. I believe this helped the market to cope with the day's delivery problems.

J.L. Kichline
October 1, 1985

FOMC BRIEFING

Since the last meeting of the Committee, information that has become available on the economy suggests activity has picked up a little. In reassessing the staff forecast, we interpreted the information as consistent in the aggregate with expansion of real GNP at a 3 percent annual rate in both the third and fourth quarters of this year--about the same as in the previous forecast.

One of the first signs of an improved tone to the economy was provided by the labor report for August. There were good gains in payroll employment, including a rise in the manufacturing sector following months of decline; the unemployment rate fell 0.3 percentage point to 7.0 percent. Those data seem, however, to have been influenced by seasonal adjustment difficulties, especially with the movement of youth out of the labor force, and we could soon see a small uptick in unemployment rates. Our reading of developments in the industrial sector also suggests some caution in judging production trends. Industrial output rose 0.3 percent in August, with gains across a variety of areas, but production for several earlier months was revised downward.

In the consumption area, spending was very strong in August, and probably in September as well, given the surge in auto sales. There has been a terrific response to the concessionary finance terms offered by domestic producers and domestic car sales in late August through the first 20 days of September have averaged around 12 million units annual rate. But most of this we believe to be transitory--basically selling 1985 models now rather than later--so that it will influence mainly the mix of sales and inventories in the third and fourth quarters. Auto producers, in fact, are scheduling little change in production in the fourth quarter compared with the preceding quarter. Outside of autos, spending on consumer goods hasn't shown any particular strength and we anticipate moderate spending increases through 1986. The possibility of sustained sizable gains in consumer outlays is limited by the already low saving rate and high debt burdens along with prospective growth of real disposable income that is not too exciting.

We have been counting on the housing market to perk up in response to earlier declines in interest rates. It seems to be doing that, but not by a lot, and projected housing starts have been reduced somewhat. There are some strong positive indicators in the market, such as home sales and permits, but single-family starts have not demonstrated the extent of response that we anticipated earlier. It may well be that the tightening of mortgage lending terms and uncertainties about tax reform are larger negative influences than thought. Nevertheless, the current projection of residential construction still provides support to GNP growth through 1986.

For business fixed investment there is little new to report. Following two very strong years of expansion, business fixed investment in real terms is expected to rise only about 3 percent and the same in 1986. Indicators of future spending on the whole remain sluggish and with ample capacity and moderate growth of final sales there do not appear to be pressing reasons for many firms to undertake aggressive expansion efforts.

The net export area currently is difficult to interpret in light of major statistical problems, although it does seem that there was no further deterioration in the trade balance in the third quarter and maybe some improvement. Looking ahead, the G-5 initiative induced us to change the projected path of the foreign exchange value of the dollar. For this forecast we have assumed the dollar value by year end 1986 will be 20 percent below its second quarter 1985 average, a 5 percentage point lower value than incorporated in the previous projection. Much of the drop has already occurred, and the somewhat larger and faster fall of the dollar leads to stronger performance of exports, thereby boosting domestic production.

The fall in the dollar also is expected to entail higher import prices, cutting into import volume and adding to domestic inflation. As measured by the GNP deflator, inflation next year is expected to come in at 4 percent, 1/2 percentage point above that anticipated this year. The recent data on prices and wages actually have been quite favorable and in the absence of the dollar impact we might have been inclined to chip a couple of tenths off of our previous projection of inflation.

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FOMC Briefing
SHAxilrod
9/30/85

Since the last meeting of the Committee, it has become clearer that the FOMC's long-run target for M1 pertaining to the second half of this year is in all likelihood not practically attainable. Because of that we have suggested a new paragraph in the directive for Committee consideration which indicates that M1 growth above the long-run range would be appropriate or, alternatively, acceptable. Of course, the Committee may not feel the need to express itself on the growth range at this point, or not through a formal change in the directive. But the economic issue of whether, or to what extent, an effort should be made to bring M1 close to its range remains. All of the short-run policy alternatives presented to the Committee would leave M1 well above its long-run range by year-end although I would not discount the possibility of a much sharper slowing than we had projected given the huge build-up in liquidity that has been already experienced.

From one perspective, the longer the strong M1 growth continues, the more natural is it to be troubled about its potential for excessive demand pressures. There is good historical reason for this. Over the past 25 years, eleven periods can be identified of acceleration in M1 (using two-quarter moving averages) that lasted two quarters or more and involved an acceleration of 2-1/2 percentage points or more (and most were substantially more). In all but two of those periods nominal GNP also accelerated significantly with a one-quarter lag, and in all but four with a two-quarter lag. Thus, whatever the underlying economic reason for the money to GNP relationship--and it is possible that both money and GNP are being affected by interest behavior but with the lag between rates and money shorter than that between rates and GNP--the relationship appears to be fairly consistent in direction, though it has been less so in degree. Incidentally, we tried the same test with M2. Acceleration phases in that variable too showed a relationship with accelerations in nominal GNP, but the correlation coefficient between M2 and GNP lagged one quarter was noticeably weaker than in the case of M1.

While history provides cause for worry about the behavior of M1, one of the exceptional periods I noted appears to be in process. To attempt to understand the reason for exceptions, we searched for other variables that might more or less consistently behave differently in "exceptional" periods than they do in more normal periods. Though not entirely infallible in that respect, the behavior of the nontransactions component of M2, and to a degree of M2 itself, was either not accelerating much or actually decelerating in "exceptional" periods. In the current period the nontransactions component has decelerated, in part reflecting large shifts of funds out of the small time deposit component of M2 into more liquid deposit assets, including the NOW account component of M1. Such shifts do not affect M2 of course, but in the current period they have occurred when M2 is not accelerating in any event.

Of course, one cannot really be sure that past relationships between M1 and GNP will not soon reassert themselves. Perhaps the disparate behavior of M1 and M2 and other associated unusual developments in the current period, such as the still apparently high level of real interest rates, give some assurance that they will not over the near-term.

But another element that needs to be considered at the present time is the exchange value of the dollar. Its relatively high and rising value over the past few years has, as the Committee knows, acted to restrain price increases and also production and employment in a number of sectors of the economy. A drop in the dollar will tend to have reverse effects, exerting upward pressures on prices and stimulating economic activity. If the drop occurs exogenously as a result of changing foreign investor preferences and is not the result of endogenous changes in the U.S. economy associated, for example, with a reduced budget deficit or simple economic weakness, the pressures will have a much greater chance of manifesting themselves in an actual acceleration of prices. The sharper the drop in the dollar, the greater would be near-term price pressures.

A sharp drop well beyond what has already developed could occur if foreign investors lose confidence in the dollar at current interest rate levels. The decline in the dollar may be moderated if at the same time upward pressures on interest rates emerge, or were permitted to emerge, so that it remained attractive to continue net placement of money here to finance the still large current account deficit, which responds to the exchange rate declines with a lag. But if interest rates do not go up, and investors have at the same time lost their appetite for dollars, the exchange rate may then tend to fall to well below the value needed in the long run to restore current account balance, and the necessary capital inflow will be provided by funds attracted to the U.S. on the speculation that the dollar will rise in the future. Thus, a large-scale shift away from dollar assets promotes the potential for inflation through a rapid exchange rate adjustment and also in my view promotes the potential for recession, given the sensitivity of certain economic and financial sectors at this point to significant interest rates increases.

I am not intending to say that the recent G-5 intervention operation has itself driven the dollar to the point where the Committee's problems are being unduly compounded. Indeed, there are obvious advantages to some decline in the dollar before the economy becomes excessively unbalanced. I am only pointing to the risk under present circumstances that, given the probable underlying vulnerability of the dollar, a rather large-scale dollar selling wave could be set off--something that has not yet been evident.

Behavior of the dollar in exchange markets has already become one of the key elements noted in the operating paragraph of the directive. We have not suggested any additional directive language to reflect the policy toward exchange markets stemming from the G-5 meeting partly because the existing language seems general enough to cover whatever weight the Committee may wish to place on exchange market developments over the weeks ahead. We have, however, suggested an alternative structure for the operating paragraph--variant II--for consideration as better reflecting the way the Committee has recently been implementing policy. The language places the aggregates and other economic and financial variables, including the exchange rate, more or less on the same footing in affecting inter-meeting changes in bank reserve pressures.

To the extent that the Committee wants the aggregates to serve as something of a cutting edge for policy, the proposed variant becomes less relevant. There is some argument at the present time for letting the aggregates--at least as a group, if not M1 itself--serve in some degree as the cutting edge. That case, in my view, would revolve around the potential for greater price pressures should the dollar decline precipitately. Such pressures would tend to make restraint on money more necessary and also more understandable. In the immediate market environment, where significant upward price pressures are not evident, changes in the directive--whether in the operating paragraph or in relation to the long-run targets--might also need to be assessed aginst the impact they might have on market psychology and on the market's perception of Federal Reserve intentions. If the Committee were viewed, for instance, as having changed the directive because it had become more willing to let money grow in order to accommodate to foreign exchange market developments, that could in the end, depending on such circumstances as the actual behavior of money and prices, fuel inflationary psychology and be generally counterproductive to the Committee's basic policy posture.